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Supreme Court of the United States

October Term, 1945.

No. 359.

STOCKHOLDERS' COMMITTEE OF THE UNIVERSAL LUBRICATING SYSTEMS, INC.,

Petitioner,

vs.

AUSTIN L. STALEY, Trustee in Reorganization for the Universal Lubricating Systems, Inc.

REPLY BRIEF.

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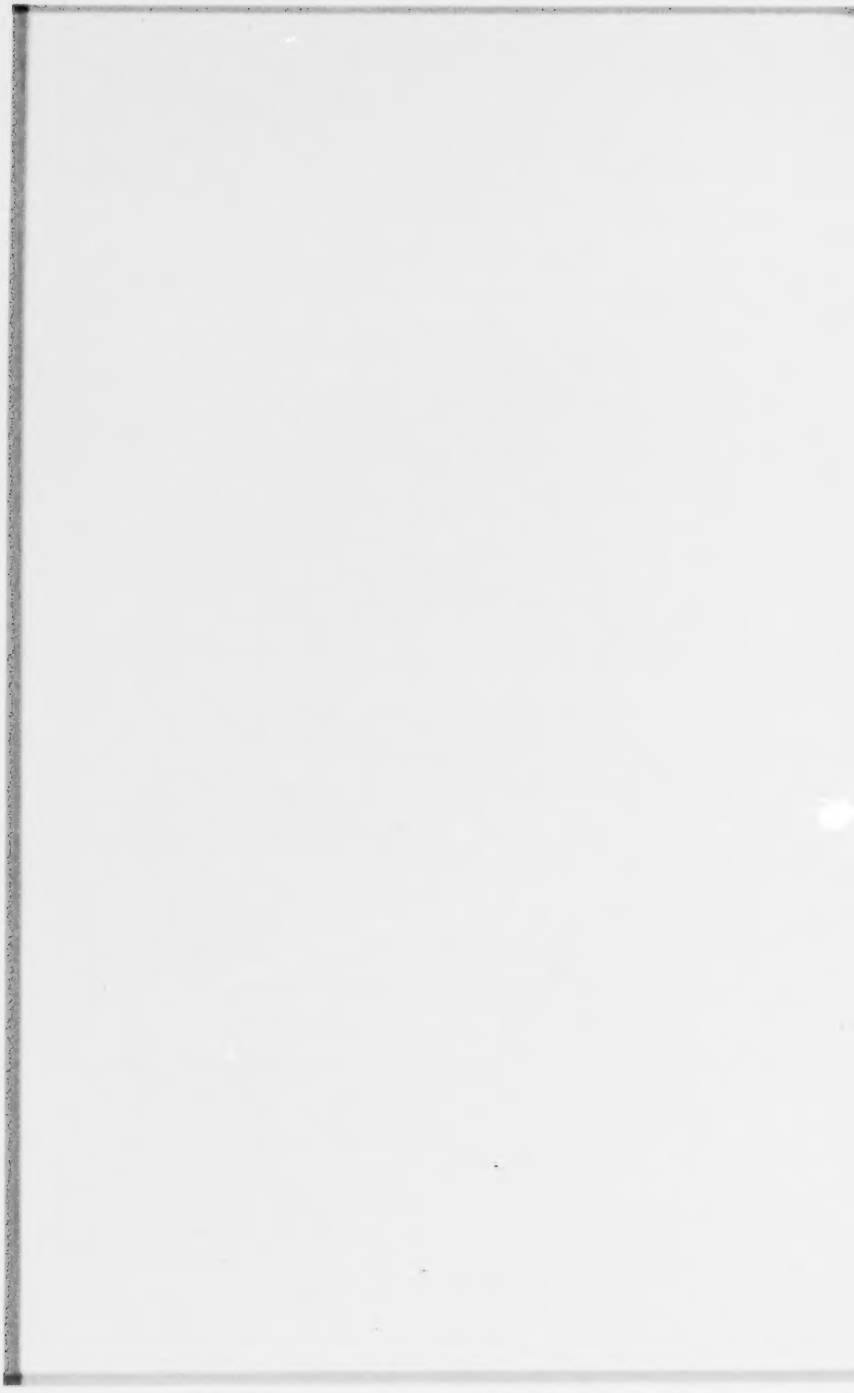

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To the HONORABLE HARLAN FISKE STONE, CHIEF JUSTICE, *and the Associate Justices of the United States Supreme Court:*

The controlling issue herein is whether Universal Lubricating Systems, Inc., (hereinafter called Universal), is solvent, which depends on—

(1) whether the valuation should have been on earnings;
(2) whether two claims of Universal, one against Stewart-Warner Corporation and the other against Christian Brynoldt, should have been valued;
(3) whether a patent belonging to the Universal company should have been valued; and
(4) whether the valuation made by the Master and approved by the two courts below, was correct.

The Trustee, in his brief, quotes and relies on the opinion below, and the questions raised by him will be briefly answered.

I.

The Master and the two courts below erred in refusing to value Universal on earnings. All the evidence required such a valuation.

The court below stated as its reasons for refusing to value on earnings,—

(a) "The * * * corporation * * * since 1932 and up to 1941 lost money every year but one." * * * the Special Master stated that "the losses may have been due to litigation with Stewart-Warner, though he did not so find as a fact." (Opinion, p. 5.)

The proof clearly shows that no real losses occurred during these nine years but that the apparent losses were in effect and should be considered profits. We quote the evidence as follows:

1. Kalish, the attorney for Universal, states that it lost $2,000,000 through Stewart-Warner's unfair competition. (App. 125a, 130a.)
2. "* * * that litigation" (Stewart-Warner), "extending over a number of years, has occasioned the expenditure of a great amount of money." (Plan, p. 4.)
3. This admission by the Trustee and the testimony by the attorney are undisputed, and they are conclusive that the 1932 and 1941 losses were from unfair competition, and not a recurring loss or due to the business, (Jones on Evidence, 2d Ed., §1005, p. 1847), but are the equivalent of an annual profit for the 9 years of over $200,000 a year, instead of a loss as the court below mistakenly states.

(b) In continuation of standing up under a loss of $200,000 a year through unfair competition, equivalent to a profit of that much per year, Universal under the disadvantage and expense of bankruptcy, has continued to earn large profits, adding to the proof which, all of it, requires a valuation on earnings.

1. For 1943, the profit was $151,008.42;
   For 1944, the profit was $124,046.56;
   From May 1941 to Sept. 1944, 3½ years, the profits were ..... $196,625.72.
2. The claims not disputed by the Trustee amount to ..... $397,927.61.
   The dividend on the preferred stock, at 6% will amount to less than ..... $ 24,000.00.
   So, on the average of earnings for the past two years, (much more on the $200,000 for the 9 years from 1932 to 1941), the earnings will amount to over 5 times the requirements for preferred stock dividends.
3. The increase in net worth in the 3½ years of bankruptcy has been such as to require a valuation on earnings. When the order adjudging Universal a bankrupt was made,—
   the debts were $331,661.18;
   the assets were ..... $ 63,909.16,
   (Schedules in Petition for Bankruptcy).
   The present value of the physical assets, not counting the Stewart-Warner or Brynoldt claims or the patent, concededly amount to ..... $327,000.00.
   Debts admitted by the Trustee are ... $397,927.61.
   So, in a short period, 3½ years, despite the expense of bankruptcy and the inefficiency inseparable from it, the assets have grown five times as high as they were when Universal was adjudged a bankrupt, while the debts have increased only 1/5th beyond what they were then. (Amended Plan, p. 5.)

(c) Next, the court below mistakenly held that,—

"* * * such prospects," (good prospects for the business and increased production through installing more

efficient machines), "do not furnish an argument for capitalization of earnings to show present worth when the earnings have come under the highly artificial stimulus of war production and an unusually favorable tax situation."

1. The general prospects of Universal's business are very exceptionally promising. To save referring to the findings of the Master, they are repeated here as follows,—

"there is a probability that in the future there will be a great and increasing need of lubricating devices such as are manufactured by debtor, and for similar equipment." (July M. R., Para. 13, p. 29a.)

"* * * the Trustee thinks that by buying one machine at a time and selling some of the old ones, a modern plant would be built up which would have a small but profitable business and be able to compete with any competitor at any price." (*Id.*, Para. 15, p. 30a.)

"The industrial business has recently been profitable * * *." (*Id.*, Para. 11, p. 28a.)

"The evidence shows grounds for expecting success for the reorganized company if it has adequate working capital." (*Id.*, Para. V, p. 50a.)

"The prospects for the entire line of fittings including this coupler are a great deal brighter than they were at the time of the previous hearing." (Oct. M. R., Para. 4, p. 62a.)

"In the Trustee's opinion, if there is a prompt reorganization and building up of the key personnel, the company will have profitable operations to such extent as to be able to maintain dividends on the preferred stock and possibly to pay it off over a period of years." (*Id.*, Para. 7, pp. 63a, 64a.)

2. There is a special reason why the earnings will be much greater in the future than in the past:

Universal's profits in the future should be 5½ times as great as they have been in the past, owing to the fact that new machinery (which has been partly and will be wholly acquired), is that much more efficient. (July M. R., Para. 14, p. 30a; Oct. M. R., Para 6, p. 63a.)

3. The objection of the court below to capitalization on recent earnings, that there had been an especially favorable tax situation, is not well taken:

Tax credit for 1944 was about	$ 70,000.00,
and as the earnings for the 2 years of 1943 and 1944 averaged	$135,000.00,
a year, a net profit of	$ 65,000.00
would have remained if the taxes had been paid, and as the debts amounted to only	$400,000.00,
and the dividends to only	$ 24,000.00,
the profit of $65,000 remaining would have paid the dividends in full and left	$ 41,000.00
to redeem preferred stock.	

Moreover, the court will take judicial notice that a new bill reducing taxes, especially for small businesses, is about to be passed, which the court below should have taken into account and not have considered simply present high taxes.

4. Nor was the objection of the court below that the earnings of 1943 and 1944 "have come under the highly artificial stimulus of war production" well taken:

> As the far larger part of the manufacturing of the country was of war munitions these years, if that were an objection to valuing on earnings, there would be practically no valuations on earnings in the country. Moreover, as appears from the findings of the Master quoted above, under (a), Universal will have far more business than it had during the war.

(d) The court below concedes that the capitalization should have been on earnings except for the two objections described above, and as they are both invalid, the effect of the opinion, (disregarding them), is to find that earnings should have been adopted as the measure of the value of Universal's property.

(e) That the valuation should have been made on earnings is made additionally clear by the fact that the failure to use

earnings as a measure of value was in conflict with all of the findings in the case; and the court below had no new facts upon which to decide contrary to the findings of the Master and the allegations of the Trustee and the evidence of the only witness.

The Trustee, the Master and the witness all knew the facts as to the government business and as to taxes, but none the less were of the opinion that the reorganized company would be really prosperous. Instead of the loss of government business being a damage, it may well be a marked advantage: it is established in the evidence and findings that there will be an abundance of Universal's kind of business,—that it will be a seller's market and not a buyer's,—and prices and profits will not be limited but will be subject only to agreement and naturally be high, and there will be no renegotiation.

(f) The refusal to value on earnings was vital since, taking the average of earnings of $135,000 a year for 1943 and 1944, at ten times this amount, the value of Universal's property would be $1,350,000,—3 times the aggregate of the debts, (*Puget Sound Power and Light Co. v. City of Puyallup*, 51 F. (2), 688, 694).

II.

It was a vital error to "extinguish" the Stewart-Warner claim, and providing that the present stockholders own the claim subject to payment of Universal's debts is far from curing the damage, as the claim, through being "extinguished," became unavailable on the asset side to determine the real issue here,—that of solvency of Universal.

(a) The court below bases its refusal to value the Stewart-Warner claim on the following mistake of fact,—

"We have not, of course, the faintest notion of the strength of the debtor's case nor the defendant's defense in the forthcoming litigation."

1. The court was fully advised that the debtor has an unusually strong case. Universal's attorney states that it lost $2,000,000 through Stewart-Warner's unfair competition, (App. 125a, 126a, 130a), and that he is entirely satisfied that he "can prove liability up to the hilt." (*Id.* 127a.)

2. The District Court has authorized the Trustee to spend the money necessary to continue this litigation. (July M. R., Para. 20, p. 32a; Oct. M. R. IV, p. 72a.)

3. The District Judge and the Circuit Court of Appeals both recognized the probability of recovery by the debtor,—the District Judge by providing how the proceeds should be distributed, and the Circuit Court of Appeals by affirming the provision. (App. 132a, 133a, 104.)

4. The Plan states,—

"* * * recent decisions on the primary questions involved in that litigation have been favorable to debtor, and *there is every reason to expect there will be a substantial recovery by the debtor's Trustee in the final stages of that litigation.*" (Plan, p. 4.)

This allegation in the plan, (the Trustee's Pleadings), is conclusive evidence, (*Jones on Ev.*, 2d Ed., §1045, p. 1847.)

5. On the proof, debtor is entitled to recover $2,000,000, and the presumption in equity is that it will recover the amount due it. (*30 C. J. S.*, §104, p. 506.)

6. As the Stewart-Warner acts were wrongful, only the best proofs available will be required. (*Eastman Co. v. So. Pac.*, 273 U. S. 359.)

(b) The court below erred in holding that,—

"* * * there was no error in not including this claim in the evaluation of debtor's property and that the provi-

sion made for the disposition of the net proceeds is both fair and feasible."

The real and controlling issue here is whether Universal is solvent, and the refusal to value this claim made it impossible to add the amount at which it should have been valued to the asset side of debtor's property; and again the error was vital because any fair valuation of this claim would have shown the debtor to have a large surplus beyond being solvent.

III.

Debtor's claim against Christian Brynoldt for damages for slander of title is covered by the petition and original brief, and therefore will not be discussed here. (Petition, p. 2; Orig. Brief, pp. 20, 21.)

IV.

The court below approved the Plan, but made no separate finding as to the claim of Christian Brynoldt, which the Master allowed at $71,011.35, (App. 23a), a large part of which is clearly invalid.

(a) After Universal had suffered huge losses through Stewart-Warner's unfair competition, in 1936 it obtained loans from Brynoldt who exacted an agreement that if his loans exceeded $20,000 all debtor's machinery, materials, and manufactured stock would become the property of Brynoldt. In 1937, his indebtedness exceeded $20,000, whereupon he exacted a bill of sale of all this property and a lease from debtor of its own property for 3 years and 11 months, at $500 per month plus 6% interest, amounting, without the 6%, to $23,500, the total of his loan. (Plan, p. 49.)

The property claimed consists of 148 items, (Plan p. 55), and is practically the same as that which the Master found worth $327,000. Brynoldt acquired besides, title to a patent belonging to debtor and 75 shares of preferred and 3800 shares of common stock,—all, so far as appears, for the $23,500. (*Id.*) Brynoldt and his attorney, with a third person, filed the petition in bankruptcy.

(b) As Brynoldt knew that Universal was heavily encumbered with debt, equity will relieve Universal from its bill of sale on account of the advantage taken and the hardship inflicted. (*U. S. v. Beth. Steel*, 315 U. S. 328, 329.)

(c) The Trustee recognizes the rule in the case last cited:

> "The Trustee believes that there is but remote possibility that Brynoldt could establish his claim of absolute ownership." (July M. R. p. 34a.)

(This is a conclusive admission that Brynoldt's claim of title was baseless. *Jones on Evidence*, 3d Ed., §272, p. 405.)

(d) As the title to the patent depended on the same gross want of consideration as that of the other 148 items of property, it will revert to and become a part of the debtor's assets.

(e) Despite the fact that the bill of sale is invalid and that no rent could accrue under the lease, the Master allowed Brynoldt his baseless claim for rent at ..... $29,316.00.
This should be subtracted from the $71,011.35,
which would leave the claim $41,695.35,
which would be offset by the debtor's claim of damages for slander of title.

(f) Despite the fact that this gross attempt at over-reaching by Brynoldt was fully covered by the stockholders' brief in the court below, and fully argued orally, the court below fails to say a word on the subject, which is wholly inexplicable.

V.

All the facts as to Brynoldt's unconscionable attempt to force a conveyance to him of debtor's property at a tenth of the value of part of its physical property and a sixtieth on earnings, are undisputed, and the Trustee not alone strenuously advocates the allowance of Brynoldt's wholly invalid claim of $29,316 for rent, (of property which he never owned), but besides, makes Brynoldt the favorite creditor and controlling figure on the Board of Directors of the reorganized company, a plain breach of his duty toward the stockholders.

(a) "The trustee believes that there is but remote possibility that Brynoldt could establish his claim of absolute ownership." (July M. R., p. 34a),

a conclusive admission that Brynoldt's claim of title is baseless. (Jones on Evidence, 3d Ed., §272, p. 405.)

Yet, in face of his own admission that Brynoldt had no title to Universal's property and of course could not lease what he did not own, the Trustee not alone advocates the allowance of $29,316 for rent, but terms the stockholders very proper attack upon it, "senseless." (Trustee's Brief, p. 13.)

(b) Moreover, despite Brynoldt's unconscionable attempt at over-reaching Universal, (continued in this Court by the attempt at justification of the invalid claim for rent), and despite Universal's claim against Brynoldt for slander of title and the adverse interest of the parties growing out of their claims, the Trustee makes Brynoldt the favorite over all other creditors by proposing to pay him, alone, about one-half of his padded and invalid claim in cash, and also makes him the controlling figure on the Board of Directors by making him personally, and his attorney, and the

Trustee, (the brother of his son-in-law), all directors of the reorganized company, (Plan, pp. 13, 14), in conflict with his duty as trustee towards the stockholders who still, even under the decision below, remain the owners of the Stewart-Warner claim, subject only to the lien of the creditors for payment of their claims. (Gerdes, §§348, 349, 356, 390, pp. 536, 537, 545, 586.)

(c) The Trustee failed in his duty toward the stockholders in that,—

1. He alone, without creditors support except that of Brynoldt, has advocated the invalid rental claim of Brynoldt, whereas his duty was to be impartial. (1 Gerdes, §390, p. 586.)

2. He improperly selected Brynoldt, with large interests adverse to those of the stockholders, as a director, as well as Brynoldt's attorney and the trustee, himself, (a brother of Brynoldt's son-in-law). (*Id.*, §§348, 456, pp. 536, 537, 545, See also *Dudley v. Mealy*, 147 F. (2) 268, 272.)

VI.

The proposed reorganization is most unjust and unfair to the stockholders in two respects,—

(1) In making the stockholders the owners of the Stewart-Warner claim, and yet depriving them of any control over its enforcement, but putting that in the unrestricted control of the Trustee; and

(2) In providing that, if the creditors are paid in full from the proceeds of the Stewart-Warner claim, they shall be made a gift besides, of all debtor's property, (worth in physical assets alone, approximately $400,000, and on earnings, $1,350,000).

(a) The effect of the decision below as to the Stewart-Warner claim is to make the present stockholders the owners, subject to a lien of the creditors for payment of their claims. The attorney in the case estimates the damages at

$2,000,000, which would be trebled, and states that he "can prove liability up to the hilt." So, the claim is a very large one, and the stockholders are vitally interested in the suit being conducted in the best manner possible for their interests.

> Despite their ownership, the stockholders are deprived by the Plan of any control whatsoever over the case. Instead, the Trustee is given unrestricted control of it, personally and quite apart from the Directors of the reorganized company. (Plan, p. 17.)
>
> In view of the unconscionable attempt of Brynoldt to acquire Universal's property at a tenth of the value of part of its physical property or a sixtieth on earnings, by converting a loan into a sale, and the Trustee's persistent and strenuous advocacy of Brynoldt's invalid claim for rent and his making him a favorite creditor and the controlling figure on the Board of Directors, the stockholders do not feel that their interests are safe in the Trustee's hands or that they should be excluded, (as they are), from any control or direction of the Stewart-Warner litigation.
>
> The stockholders, as the Trustee states, suffered "the expenditure of a great amount of money," (Plan, p. 4), in the Stewart-Warner litigation; for 9 years they were deprived of any dividends; and then their company was forced into bankruptcy. The recovery of the unjust damage sustained by them is their chance to recoup for the prolonged injuries they have suffered. Under such circumstances they themselves should be given a chance to protect their interests in this litigation.

(b) If enough is realized, the creditors will be paid in full from the proceeds of the Stewart-Warner claim. Yet, they will, under the Plan, become in addition the owners of all

debtor's property, (aside from the balance of the Stewart-Warner collection), worth, capitalized on earnings, $1,350,000,—three times the amount of their claim. This would be an outright gift.

There is no reason for the creditors receiving anything more than full payment, since their position is not made less secure, but far more so through the plan of reorganization. They, through preferred stock, will have the first lien on earnings of the company and, besides, they are given a specific lien on the Stewart-Warner claim which is for five times the amount of the debts.

There is no justification for the attempt to make the creditors a gift of all debtor's property besides paying their claims in full.

Conclusion.

1. The proof here requires a valuation on earnings, in accordance with the oft repeated rulings of this Court, viz,—

The objections of the court below were, that there were losses from 1932 to 1941, but

The proof shows clearly that these were, in effect, not losses but profits, due to unfair competition.

Next, the court below said—"the average profits of $135,000 a year for 1943 and 1944 were not a measure for capitalization, because of the artificial stimulus of war production and a favorable tax situation", but,—

The Master's findings, the Trustee's statements, and a highly competent witness, all testify that the pros-

pects of the business are most promising; that it would have more rather than less business, not subject to profit restrictions, with a seller's not a buyer's market, and higher prices; and if the taxes had been paid, the remaining profits would have paid the preferred dividend and leave a large surplus; and a new bill reducing taxes for small businesses will undoubtedly be passed within a few weeks.

Debtor's large earnings have been despite the inefficiency and expense of bankrupt operation, emphasized by the court below, and despite the expense of the Stewart-Warner litigation.

2. The court below based its refusal to value the Stewart-Warner claim on its not knowing the strength of the debtor's case or the defendant's defense, whereas it was fully advised by Universal's attorney that he "could prove liability up to the hilt," and that debtor's losses through unfair competition were $2,000,000; the District Court has authorized the expenditure to continue the litigation; and the two courts below provided for distribution of the amount of recovery; and the Plan states,—

> "There is every reason to expect there will be a substantial recovery * * * in the final stages of that litigation,"—

conclusive evidence.

3. Brynoldt attempted to obtain title to debtor's physical assets, worth as such about $400,000, and on earnings $1,350,000, for $23,500. The Trustee states—

> "There is but remote possibility that Brynoldt could establish his claim of absolute ownership."

4. The courts below sustain the claim of Brynoldt for rent of this property, which he never owned. His whole effort to overreach was abortive. The court below sustained this wholly invalid claim for rent.

4. The Trustee has strenuously and persistently advocated, contrary to his duty, Brynoldt's invalid claim for rent, and despite Brynoldt's adverse interest, has made him, his attorney, and the trustee himself, (a brother of Brynoldt's son-in-law), directors of the reorganized company, and provided that Brynoldt, alone, of all the creditors, should be paid half his padded and invalid claim in cash,—a failure of duty to the stockholders.

5. Two proposals are wholly unjust,—(1) that the creditors be paid in full from the proceeds of the Stewart-Warner claim, and if they are so paid, they receive besides, all debtor's physical property, (except the balance of the proceeds of the Stewart-Warner claim) worth as such $400,000, and on earnings $1,350,000; and (2) the provision that the present stockholders be the owners of the Stewart-Warner claim, subject only to payment of the creditors' claims, but excluding them from any voice in the Stewart-Warner action, whereas they feel no confidence in the trustee's conduct of it, in view of his advocacy of Brynoldt's rental claim and his preference of Brynoldt otherwise.

For all these reasons, it is respectfully urged that certiorari should be granted and the judgment of the court below be reversed.

Dated: September 24th, 1945.

Respectfully submitted,

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